JPMorgan
thought
securities lending QUARTERLY

Letter From Sandie O'Connor

Second Quarter 2006 Edition

Table of Contents

Market Conditions Prompt Favorable Spreads, Increased Earnings for Clients in Second Quarter 2006

Sandie O'Connor

Welcome to the *2Q06 Edition* of the *JPMorgan Securities Lending Quarterly*. As always we discuss trends affecting the securities lending industry and review our lending program, its performance, and the strategies used to maximize clients' earnings.

This issue of the *Quarterly* is significant as it marks one of the first major communications to our lending clients since I joined Securities Lending in May. Beyond all the excitement and demands associated with this change, I am fortunate to lead a sophisticated franchise that possesses unrivalled scale, scope and depth. My goal is to advance it further by leveraging best practices and delivering superior value to you, our invaluable clients.

Already, clients have spoken to me about the importance of flexibility. I believe one of the primary sources of our success is our ability to align our strategies and structure to most effectively meet the needs of clients. Avi Stein nurtured this ideal, which resulted in ground breaking products and excellent client service. Going forward, I'll look to Avi for insight while using my own experience to assess our programs, capabilities and potential. In particular, my background in interest rate and liquidity risk management will be useful given its relevance to securities lending. Most of all, I eagerly await the opportunity to meet you, so I may serve as a conduit for your ideas and feedback.

Auspicious Backdrop Prevails for Lending

During this quarter, we entered dividend season with indices trading at high levels, in both U.S. and International Equity markets. We saw client balances grow as a result of the dividend yield-enhancement season, and we executed on strategies which capitalized on the generally favorable lending environment in Europe. Meanwhile, we benefited from increased activity in the convertible bond market, and also from the anticipated and significant U.S. Treasury collateral shortage which fueled wider spreads. This, combined with our on-target interest-rate forecast and reinvestment strategies enabled us to deliver strong client earnings this quarter. In particular, our decision to focus on prime-based floating-rate securities not only reaped rewards during the quarter, but has also positioned our cash book well for the coming months.

continued

Letter From Sandie O'Connor (cont'd)

From a more tactical perspective, we continue to proceed with our negotiations regarding the addition of *Performance Explorer* to VIEWS reporting. If you haven't already, you should be receiving a letter from your securities lending representative regarding the rollout of this exciting feature which, when added to your reporting capabilities, will allow you to compare performance of your program.

In line with our commitment to outperform the competition with regard to client reporting, we're happy to announce that David Lewis, formerly of *Performance Explorer*, has agreed to join our product development team in Europe. While David will be focusing on the needs of our lending clients in spearheading product development, he will also provide invaluable counsel and direction as we rollout *Performance Explorer*.

International Securities Finance Survey Awards Recognition

We are especially pleased with the recognition JPMorgan received recently from *International Securities Finance*, where we ranked favorably in that publication's 2006 Annual Repo Survey. We are delighted to have topped the unweighted section of the survey, in addition to capturing a lead spot in the cash-provider weighted category. We view such third-party recognition as a testament to the approach and vision that drive our ongoing efforts to serve *all* segments of our client base.

As we look to the balance of 2006, there continue to be many opportunities for growth, development and advances in the way we do business and service our clients. The management team and I are focused on key initiatives to enable us to continue to leverage our franchise to deliver the products and value that you, our clients, expect. We look forward to discussing our perspectives further at the *11th Annual European Beneficial Owners' Securities Lending Summit* in Barcelona this September. As a sponsor, we'll be well represented there, with many senior members of our lending team on hand to meet with you and discuss important issues affecting the lending climate as well as your individual programs.

As always, we value and encourage your input on every aspect of our program, including the *Quarterly*, and I welcome feedback from each of you. While our business and the markets continue to evolve and change, we remain mindful of our aspiration to continue to add value to your programs and of the privilege it is to serve each of you.

Sandie O'Connor
Managing Director & Business Executive
JPMorgan Securities Lending & Execution Products

From the Investment Desk

Interest-Rate Environment Dominates Second Quarter 2006

If there was one prominent theme that prevailed during the second quarter of 2006 with persistency, it was the market's overall uncertainty surrounding the perceived neutral interest rate.

As the quarter began, the market seemed certain that the FOMC would raise the target overnight lending rate to 5% at its May 10 meeting. However, the market rallied several times during April, at times causing longer-dated prices to move by as much as six to seven basis points. This was in reaction to the release of the previous Fed meeting's minutes, and to statements made by Fed Chairman Ben Bernanke, who remarked that a decision not to take action at the upcoming May meeting would not necessarily preclude action at subsequent meetings. This led to heightened uncertainty regarding not only the May FOMC meeting but also June's. According to fed funds futures levels in April, the probability of a rate hike in June went as low as 30% before leveling off at 50%. Since economic data available in April still supported the overall view that growth was strong and inflation stable, the market's expectations regarding Fed actions were at best mixed.

When May began, economic data released only added to the murkiness. Good news for the bond markets came in the form of a payroll report below consensus, but that was offset by the fact that hourly earnings were higher than expected, up 0.5% on top of an upward revision to the 0.3% reported the previous month. At the same time, the market became concerned regarding the "lag effect" of the Fed's policy and the possible danger of tightening too much, thereby choking off economic growth. While uncertainty prevailed throughout the first several weeks of the quarter, immediately before the May 10 meeting, the market exhibited confidence that the FOMC would hike the fed funds rate by 25 basis points to 5% (marking the 16th rate hike since June 2004), which in fact it did.

In addition, the Fed altered its official statement to provide greater flexibility and highlight the data-dependent nature of the current policy landscape. The key statement read, "The Committee judges that some further policy firming may yet be needed to address inflation risks, but emphasizes that the extent and timing of any such firming will depend on the evolution of the economic outlook as implied by the incoming information." This message left the door wide open for the Fed as it headed toward the end of the quarter and its June 29 meeting. A higher-than-expected CPI number released late in May/early June increased worries that further rate hikes might be necessary, and throughout May, the probability that the Fed would move rates at the June 29 meeting varied from 40% to as high as 80%. Ultimately, as we know, the central bank effected its 17th rate hike at its June meeting, leaving the target rate 5.25% for the quarter.

Jim Wilson

Incisive Rate Forecast, Prudent Liquidity Risk Management Help Boost Client Earnings

Here on the Investment Desk, we stood firm in our view that the Fed would move at each of its meetings with certainty. Obviously, hindsight tells us that this was an advantageous positioning, to say the least. The fact that the market's view was so cloudy, contrasting with our own expectations (driven by a high degree of certainty), created a set of opportunities in which we had to act nimbly and flexibly in order to help maximize clients' earnings.

For example, our ability to purchase fixed-rate instruments beyond the next Fed meeting was limited, due to the fact that the market was not paying us with certainty that the Fed was going to move. As a result, we continued to focus on floating-rate instruments. However, that strategy was challenged by the fact that current cash balances were being driven in large part by the dividend season, which is cyclical, and which we knew would come off by the end of June, thereby preventing

From the Investment Desk (cont'd)

us from buying floaters with what appears to be excess liquidity or excess cash to invest.

Fortunately, much like our instincts in regard to the Fed's moves, we were prepared and positioned for this challenge. We performed a client-specific cash balance/loan balance analysis, identifying the core balance in an attempt to prevent any liquidity problems. As a result, we kept the investments shorter than the next Fed meeting, due to the fact that the market wasn't paying us through the meeting, which resulted in a higher degree of overnight liquidity. This proved to be very advantageous as balances fluctuated somewhat in response to the cyclical and largely anticipated moves of international dividend season.

Overall, we continued throughout the quarter to focus on floaters, particularly 1- and 2-year AA-rated corporate floaters based on prime. Once again, in hindsight, it appears our strategy of maximizing floating-rate notes (FRNs) was perhaps the best strategic decision we could have made, even as far back as a year ago. In addition, the switch from the 1- and 3-month LIBOR to the prime index was a boon, but interestingly, because the yield curve remains upward sloping, the full benefits of that decision have yet to be realized. What will likely happen is, when the market realizes that the Fed is finally finished with its rate hikes, the spread between the 1- and 3-month LIBOR and the target rate will narrow. For example, if one investor buys 1-month LIBOR flat today, he's earning 11 basis points over the target. Meanwhile, another investor buys prime minus 288, which is 12 over the target--virtually the same. When the market becomes convinced that the Fed's next move is an ease, 1- and 3-month LIBOR are not likely going to be 11 over the target; they'll more likely be 6 or 9 over. The LIBOR flat coupon would then yield six to nine over the target while the prime minus 288 would still be 12 over, giving the second hypothetical investor a clear advantage.

The other advantageous aspect of this tactic is that we forfeited no yield to switch from 1- and 3-month LIBOR to prime. Through the swap market, where 1- and 3-month LIBOR are swapped into prime, we bought the same amount of floaters at the same price. As such, we've been able to add to our prime-based floater position as the Fed continues to tighten—a tactical strategy that will lend us a definitive advantage that will only expand when the Fed stops raising short-term rates.

While our primary focus has been on FRNs, on the fixed-rate side, the time period we pinpointed as having the most value was in the 3-month area, where we capitalized on opportunities early in the quarter to buy products that had, in fact, priced in increases at the next two FOMC meetings. Since the market was largely undecided as to what the target rate would be at the end of June, we found these trades to have high value. We also invested in the 1- and 2-month area in order to satisfy our short-term liquidity needs as we anticipated a jump in our cash balances at various points throughout the period. These investments provided returns a few basis points above the target and matured as dividend season began to wind down.

Successful Strategies, Earnings

Overall, we enjoyed a particularly strong quarter which was highlighted in May, when cash balances hit an all-time high, clients reported record earnings, international dividend season was at its peak, term mortgage lending accelerated and continued client focus reaped additional profits.

In mid-May, client balances were at their highest levels yet, while Treasury spreads were at their widest levels in some time. The maturity of $58 billion of cash management bills (CMBs) in April caused a Treasury collateral shortage that persisted throughout the period. Spreads that normally run at around 8 basis points were averaging 15. The expectation that this spread would tighten at the beginning of June led us to execute various matched-term trades in which we were able to lock up 11 to 17 basis point spreads from 3 months out to 6 six months. This shortage had two benefits: it allowed us to re-rate our bonds-borrowed program and achieve wider spreads for those clients who are in the non-cash program, and likewise, it widened the cash-reinvestment spreads for clients who only accept, for example, U.S. agency repo. For those clients who were lending U.S. Treasuries, those Treasuries were at fed target minus 10 to 15 instead of minus five, so they enjoyed

From the Investment Desk (cont'd)

an incremental 10 basis points. At the same time, by working closely with the mortgage-lending desk, we were able to lock up $3 billion agency mortgages against asset-backed commercial paper for 1-month, at spreads of 6 to 7 basis points.

Guideline Expansion Leads to Additional Revenue for Clients

Meanwhile, our efforts to inform clients on the benefits of adopting the recent changes to our standard guidelines continue to result in incremental returns for those clients who have adopted some or all of the new aspects of our standard guidelines. While some clients have elected to approve extension trades or 3-year final maturities on floating-rate investments, others have expanded acceptable repurchase collateral to include lower credit-quality corporates and equities. This election to adopt the expanded parameters within each client's specific risk/return profile has been indisputably beneficial, and it represents the responsiveness and flexibility that underscores our program.

We continue to refine our standard guidelines, largely because of the tremendous success we've enjoyed among clients who have opted for various degrees of expansion into the new guidelines. We believe, based on experience and success, that we can increase the return profile for select clients while only moderately impacting risk. For example, we are currently evaluating the viability and appropriateness of going to five years in floating-rate notes, only with extremely creditworthy issuers. Similar to our 2004 guideline-expansion initiatives, where we increased the minimum credit level up to an AA-rated and extended out to three-year maturities, our current recommendation to our various internal risk committees is to allow five-year final maturities, only with the very strongest of credit ratings: AA- and higher rated credit.

Another area that we are currently exploring in terms of refining our standard guidelines relates to expanding permissible types of repo collateral. Once again, as a continuation of the guideline adjustments we began in 2004, we are looking into the possibility of accepting lower credit-quality with a subset of our approved repo counterparty list. In previous adjustments to our guidelines, we moved along the credit-quality curve, so to speak, whereby we would limit our acceptability to AA-rated corporates and AAA-rated asset-backed securities, we moved to include non-investment grade corporates (BB-rated). While BB-rated corporates are the very highest level of non-investment grade credit, the shift was nonetheless significant. Now, we're looking at the inclusion of different asset types. Specifically, we're considering whole loan collateral, municipal collateral and auction rate certificates.

Other initiatives for us at this time include looking into expanding our current commingled offerings to our non-ERISA eligible clients through the establishment of two new Delaware Business Trusts (DBT) commingled vehicles. Those of you who are interested in exploring a commingled solution for your cash collateral should contact your Securities Lending Representative to determine if your assets qualify for this solution.

Our Outlook

Given all of the promising and lucrative initiatives we are currently engaged in, our overall outlook is predominantly positive. We are confident our efforts to offer expanded guidelines to clients whose risk/return parameters allow, will stand to reap benefits by exploring the viability of these enhancements. In addition, we are encouraged by results of our steadfast adherence to our views on interest rates and the Fed, as well as our subsequent strategies and tactics based on our analysis and research.

Our forecast remains for the Fed funds rate to reach 5.75% by year-end. We intend to continue our emphasis on floaters, as these products have consistently outperformed the fed target by at least 10 basis points. Also, we plan to take advantage of any viable opportunities to purchase fixed-rate investments at premiums based on our break-even analysis. This has indeed been a challenge for longer-dated fixed rate purchases since our interest-rate expectation remains higher than what the market has been pricing into those investments. However, we are again encouraged by the results of our proactive approach to seeking every available opportunity to add incremental revenue, regardless of market and macroeconomic conditions.

From the Investment Desk (cont'd)

Euro

Highlights:

- As the quarter opened, the euro rose, approaching an 11-month high against the U.S. dollar. This was spurred by an industry report indicating that euro-region manufacturing expanded at the fastest pace in more than five years during March.
- In April, the euro had risen 6.6% against the dollar as signs of faster growth prompted increased speculation that the European Central Bank (ECB) will increase the pace of interest-rate increases while the Federal Reserve nears the top end of a two-year cycle of raising the cost of borrowing at virtually every one of its meetings. This has also led to speculation that European bond prices will continue to fall. Ten-year debt in the region has dropped continually since the onset of 2006, pushing yields to 18-month highs. For example, the yield on the German 10-year bund, a benchmark for Europe, rose as high as 4% at the end of April for the first time since October 2004.
- Economic data, confirmed in June, indicated that real GDP grew by 0.6% in the euro area in the first quarter of 2006, compared with 0.3% in the previous quarter, with domestic demand making a significant contribution. The expected re-acceleration of real GDP growth in the first months of 2006 has thus materialized, confirming the central bank's view that economic growth is broadening and becoming more sustained. This assessment was further supported by information on activity in the second quarter – such as various confidence surveys and indicator-based estimates – which continued to be encouraging.
- In the first week of June, the ECB raised its key interest rate for the third time in seven months, responding to inflation above its target level of 2%, and possible property-market bubbles in some euro-region countries. The central bank pushed its key rate by a quarter-point to 2.75%, as had been widely expected, though there were some in the market who speculated that the bank would lift rates by a half a percentage point.
- ECB President Jean-Claude Trichet's remarks after the June meeting stressed the bank's intention to pursue price stability in order to foster economic growth and job creation. As Trichet stated, "The further withdrawal of monetary accommodation will thus contribute to ensuring that longer-term inflation expectations in the euro area remain solidly anchored at levels consistent with price stability." Trichet added that even after the June increase, the key ECB rate is still low by historical standards, liquidity is ample and the region's monetary policy "remains accommodative."
- Conditions in the region appear to be positioned for further growth, despite the impact of rising oil prices. As growth in the economies of the euro region's primary trading partners remains robust, euro-area exports should be favorably buoyed. According to the ECB, strong investment growth is expected to continue, benefiting from favorable financing conditions, corporate balance sheet restructuring and gains in earnings and business efficiency.
- At the same time, euro-region inflation accelerated to 2.5% in May, exceeding the ECB's 2% ceiling for the 16th consecutive month. Germany remains on a watch list of sorts, in that investor confidence there fell for a fifth month in June on concerns that rising interest rates and near-record energy costs would cool growth in Europe's largest economy. Adding to the worries there is the fact that a planned increase in sales taxes in Germany next year could also discourage household spending in 2007. With the value-added tax moving from 16% to 19%, the biggest increase in nearly four decades, consumer spending could indeed suffer.
- Futures trading levels at the beginning of June indicated that the market expects at least two quarter-point increases by the ECB by year end 2006.
- In the UK, inflation reached at seven-month high in May, strengthening the case for the Bank of England (BOE) to join a global round of interest-rate

From the Investment Desk (cont'd)

increases. Consumer prices in the UK rose 2.2% from a year ago after increasing 2% in April, according to London's Office for National Statistics. However, while central banks in Europe and Asia moved to increase interest rates there in May, the BOE kept its own rate at 4.5%.

- As the quarter ended, most market watchers expected the BOE to leave rates unchanged at its early July meeting (which it did). Due to a number of factors, including the fact that rising oil costs are feeding through to core inflation numbers, consumer spending not picking up as hoped and the significant restructuring occurring currently in the MPC, the market generally expects the BOE to leave rates alone in the near term. What's more, with Richard Lambert moving on to another role and David Walton sadly dying in June, it will take some time for new members of the MPC to be appointed and for them to settle into their roles, adding yet another reason to suspect that the central bank will decide to hold off on further increases for the short term.
- Meanwhile, a new survey revealed that Britain's export markets are growing at their fastest rate for six years, raising hopes that the UK economy is "rebalancing" away from over-reliance on the consumer.

Australian Dollar

In contrast to the very quiet first quarter of 2006, which contained few surprises, the second quarter was an eventful one, highlighted by an unexpected interest-rate hike in May by the Reserve Bank of Australia (RBA).

In April, domestic money-market yields, having traded within a narrow range for the previous nine months, spiked higher. Bank bill yields rose early in the quarter, with 90-day yields up 23 basis points at 5.84%, and 180-day yields up 24 basis points at 5.90% for the month. This was due in large part to the release of the Consumer Price Index (CPI) for the first quarter, which revealed some acceleration in underlying inflation, prompting the market to heighten its expectations regarding a rise in official interest rates. Indeed, economic data in general released in April took a decidedly stronger tone, led by signs of renewed resilience among consumers due to a very strong labor market. For example, headline inflation in the first quarter rose by 0.9%, leaving annual inflation 3% higher than a year earlier. Being that this is at the top of the RBA's target inflation band of between 2% and 3%, the release of these numbers signaled to the market that a rate hike was a lot closer than expected. In particular, the two RBA underlying measures – the trimmed mean and the weighted median – both accelerated in annual terms to an average annual rate of 2.7%. This increase represents a faster pace of acceleration so far this year than the RBA forecast in its February Monetary Policy Statement.

In the first few days of May, the RBA raised the official cash rate by 25 basis points to 5.75%, its first interest rate adjustment since March 2005. This move was relatively unexpected and provided the momentum and tone for trading within the domestic money market over the month. Bank bill yields rose by 7 basis points on the day of the announcement. The RBA statement following the hike centered on international developments that had provided stimulus to the economy and, significantly, forecasts for global growth had been revised upwards. The statement further emphasized that domestic spending had been growing at a solid pace and was likely to continue. It made clear that the international and domestic trends had added to inflationary pressures in an economy with limited spare capacity, and this had contributed to underlying consumer price inflation rising to around 2.75% in the first quarter. The statement did hint, however, that another rate increase was unlikely in the near term, with the RBA continuing with the firm rhetoric but waiting to gauge the impact of the move on the key indicators before deciding whether further action will be required.

The release of the Federal Government's 2006/07 budget with an upward revision to revenue indicated that economic growth

From the Investment Desk (cont'd)

in Australia remains strong. The budget also proposed tax cuts widely recognized by the market to accompany further economic stimulus efforts in the coming months.

With market uncertainty high and the avalanche of stronger-than-expected economic data, we took the view that we would minimize our exposure to interest-rate risk by concentrating our investments in the 1-month part of the curve. As the market had started pricing in a more imminent rate hike, we took advantage of the steepening front end of the curve to lock in a premium over cash and a breakeven target that was priced with a near-term hike in mind. We also took the opportunity to push volume higher on our term trades as a means of nullifying the uncertainty surrounding the direction of interest rates, but at the same time, locking up a spread over the official cash rate and riding the steepening yield curve.

We remain wary of further upward pressure on inflation and hence the probable need for the RBA to effect further tightening in the third quarter. At this writing, the futures market has priced in an 80% probability of a 25-basis-point tightening in August. To this end, we have kept our exposure on the open book concentrated in the 1-month part of the curve while keeping a watchful eye on economic data as it unfolds. We will continue to keep our term trades at their current level, as we are at maximum capacity already.

From the Trading Desks

Michelle Phillips

The second quarter 2006 was a turbulent one for equities, starting with very strong markets and high prices, followed by a large market correction in May on the back of higher levels of inflation and interest-rate concerns. This market volatility had an impact across the loan book, with strong balances at the start of the quarter transitioning to a fall-off towards the end, as loan valuations moved lower and as clients sold positions in a bout of profit-taking. Of course, yield enhancement season meant many client balances continued to grow despite the market downturn; however, as we'll discuss later, even this business was affected.

A continuing trend from previous quarters was the huge amount of private-equity money being raised by that industry, driving recent M&A activity. In other areas, a welcome sign is the improvement we saw this period in the convertible bond market. This was one of the hardest hit strategies last year, having a big impact on lending as historically this has been a big driver of demand for our business. Higher interest rates and increased market volatility have resulted in increased sales of CBs, along with the attendant need to borrow stock as a hedge.

International Equities

Europe

Lending revenues and balances from European equities hit a record high during the second quarter of 2006, as expected, with April and May the two most lucrative months for the yield enhancement trade.

Deals

Lending opportunities driven by deal activity have been weak this quarter, with fewer new lendable deals hitting than last quarter and compared to the second quarter 2005. M&A activity in the region dipped from last quarter, however, remains high overall for the first half of the year, with $782.8 billion in deals announced (compared with $453.3 billion for the first half of 2005). Continuing recent trends, most deals are straight cash deals, which offer no risk arbitrage and therefore no borrowing demand; roughly half the number of stocks were lent due to M&A activity this quarter in comparison with second quarter 2005. However, we did see a pick-up in the number of rights issues and secondary offers. It seems European companies are using these as a way to raise capital to fund to their M&A activity. Total value of rights issues this quarter exceeded the previous peak in 4Q03. Other big news in Europe was the withdrawal of a large number of IPOs, due to sharp market declines and increased volatility.

- The major M&A deal this quarter was the takeover of Italy's Banco Nazionale Del Lavoro by BNP Paribas of France, which finalized in May. Rumors of the takeover have been ongoing since February and therefore stock was already on loan; BNL due to the takeover and BNP due to the rights issue used to finance the takeover. Elsewhere in France we saw borrowing demand for Iliad SA which issued a convertible bond and also Arkema, a spin-off of Total SA, which drew directional demand. There was directional demand in European Aeronautic Defence and Space Co NV due to a big drop in price after a statement that release of the company's new "Airbus 380" may be delayed. We also saw demand in Veolia as it prepared a takeover bid of Vinci, although this subsided as the deal was abandoned due to strong opposition to the takeover from Vinci. Arcelor SA finally gave its backing to the takeover by Mittal Steel, ending five months of opposition to what will be the biggest-ever transaction in the steel industry. Borrowing demand for Arcelor shares remained strong throughout the quarter, enabling the desk to increase fees after the announcement. Of course, borrowers were looking for untendered shares, and for those clients who didn't tender, we were able to lend at even higher fees.
- In Italy this quarter we saw the trend in which capital was raised through

From the Trading Desks (cont'd)

secondary offers and rights issues, exemplified by two main deals fuelling demand. Banca Popolare Italiana announced a share sale, with the proceeds to be used to buy out two of its units as it reorganizes its business. Lottomatica S.p.A announced a rights issue to fund the acquisition of GTech Holdings Corp of the U.S.A. as reported last quarter.

- In Germany we saw short-term directional demand in Conergy AG and also Q-Cells AG as Credit Suisse managed the selling of investor Immo Stroeher's 20.5% stake in the company. There was also strong demand in Qiagen N.V., which announced pricing on $270 million of convertible bonds with proceeds to be used to optimize the structure of its balance sheet and to finance future acquisitions.
- The U.K. was our most active market for new deals this quarter with a spate of M&A activity. We saw demand for Abbot Group PLC, which agreed to buy Songa Drilling AS of Norway for $442 million; and Virgin Mobile, which agreed to a takeover by NTL, although Virgin Mobile stock was already on loan due to ongoing directional demand. Finally, in June we saw demand for Telent PLC, due to a takeover by Fortress Investments.
- In Spain we saw demand driven by two M&A deals in June: NH Hoteles SA, after Hesperia announced plans to buy 15 million shares causing a price increase in NH Hoteles of 16%, and Gruppo Ferrovial SA's takeover offer for BAA PLC.
- Turkey announced its plans to end the 15% withholding tax for foreign investors in an effort to stem losses in its financial markets. This could be good news for lending as taxation issues remain the biggest barrier to lending there.

European Yield Enhancement

The European yield enhancement season peaked in April and May, the busiest months for dividend record dates, and then fell sharply in June. Balances on the international book reached record levels over the quarter as strong demand for yield enhancement trades drove lending activity. The only negative to report was the sell-off in equities which started in May, right at the peak of the season. This had a negative impact on revenue as loan values were driven down from their peaks. In last month's newsletter we discussed levels achieved in 2006 versus 2005, and to reiterate, in general the 'all in' levels at which these loans are traded have increased from last year, and coupled with announced dividends being higher, has led to strong earnings. As the dividend season started to wind down in late June, we started to see requests to re-rate European specials as more supply hit the market and as yield enhancement loans were returned by borrowers.

Asia

Deal activity fuelling lending demand continued the strong start we saw in 1Q06 into this quarter, with levels of M&A activity and convertible bond issuance remaining high and a notable pickup in activity in Hong Kong over last quarter. This contributed to record balances achieved across the region. Demand for trades driven by directional demand picked up slightly from first quarter of 2006, although the number of new lending opportunities was still well below (25%) those seen during the same period last year.

- Australia continued in the vein of recent months with strong borrowing demand coming from a number of new deals hitting this quarter, particularly M&A activity. Consolidation among Australia's infrastructure groups is driving the takeover boom as companies see opportunities to increase efficiency by taking over competitors. Demand is also being driven by an increase in private equity activity, with Macquarie being one of the most high profile participants both in Australia and abroad. M&A activity has been growing at about 25% a year since 2000, but still lags other developed markets such as the U.S. Alinta and Australian Light and Gas reached a compromise this quarter after hostile takeover bids by each for the

From the Trading Desks (cont'd)

other in the previous quarter. An asset split was announced in April with a view to merge their infrastructure businesses; Australia Gas and Light's energy business will be spun out as a separate company with no cross-share holdings between the two companies. Stock that was already on loan (as mentioned in the previous quarter) tightened on the news. Other notable M&A activity for lending saw Futuris purchasing remaining shares in Integrated Tree Cropping, Straits Resources' takeover of Tritton Resources, Babcock & Brown's takeover of Australian Pipeline Trust, Onesteel's takeover of SMorgan Steel and Tabcorp's takeover of Unitab.

- In Japan, deal activity remained strong compared to last quarter with main drivers of demand being convertible bond issuance and secondary placements. There was also a pick-up in M&A deals that provided lending opportunities. Convertible bonds were issued by Suzuki Motor, Tobu Railway, Fuji Electric Holdings, Sojitz, Link Theory and Es Con Japan. Secondary placements where issued by Kenedix Realty Investment Corp, Sodick Co Ltd, Makino Mining and Sun Frontier Fudousan Co Ltd. M&A activity drove demand in Goodwill Group Inc, Millea Holdings, Kirin Beverage, Itochu Techno Science, Air Water Inc. and York-Benimaru Co Ltd.
- Elsewhere in Asia, Hong Kong was the star-performing market with a big upsurge in deals, particularly convertible bond issuance, secondary placements and M&A activity, plus strong demand from borrowers to hedge future's positions. Convertible bonds were issued by Hengan International, Neo-China Group Holdings and secondary placements by Gome Electrical Appliances Holdings Ltd and Melco International Development resulted in new loans. We saw demand in PCCW Ltd due to the takeover bid by Australia's Macquarie Bank and Citic International's plan to take a stake in a Beijing based lender. The futures positions resulted in borrowers requesting 'baskets' of index stocks as a hedge. These were large trades significantly increasing balances. There was directional demand in Shun TAK Holdings and Xinao Gas Holdings Ltd due to their inclusion in the MSCI Index. Finally there was the long awaited IPO by Bank of China with huge demand from the borrowing market. This was the largest IPO globally in 8 years. Elsewhere, in Asia Singapore's Keppel Land issued a new convertible bond.

U.S. Equities

Deal activity in the U.S. equity market continued its strong start to the year with demand fuelled primarily by new IPOs, as well as M&A activity and convertible bond issuance as seen elsewhere. Balances hit record highs in early May, but fell back with the general market correction.

- In April we saw healthy demand fuelled by a number of new IPOs by Visicu Inc, Sealy Corp, Omega Navigation Enterprises Inc and Complete Production Services Inc. Annaly Mortgage Management Inc issued a convertible bond, and we saw demand fuelled by M&A activity with Verifone Holdings Inc.'s takeover of Lipman Electronic, Petrohawk Energy Corp's takeover of KCS Energy and Plains Exploration & Production Co's takeover of Stone Energy. There were also Dutch auctions announced by Autonation Inc, Brink's Co and CBRL Group Inc, which triggered demand for clients lapsing their shares.
- In May, we saw a large number of new deals with new convertible bonds issued by Level 3 Communications Inc, Broadwing Corp, Amkor Technology, Merix Corp, Delek US Holdings Inc, Dyncorp International Inc, Greenbrier Cos Inc, Frequency Electronics Inc and Enzon Pharmaceuticals Inc. Convertibles were also issued by Sandisk Corp, Manor Care Inc and and JDS Uniphase Corp, but we saw no demand to borrow these names. M&A activity was strong, although we only saw demand for Mirant Corp after its takeover approach to NRG Energy. IPO activity was strong this month with demand to borrow Corel Corp, CPI International Inc, Novea Inc,

From the Trading Desks (cont'd)

BioMimetic Therapeutics Inc, Basin Water Inc, Vonage Holdings Corp and Inc. There was continued directional demand in CROCS Inc after its new IPO last quarter. However, the end of the month ended on a low note with the fiasco over the Vonage IPO, whose share price fell sharply—a sign that U.S. markets were also experiencing tough conditions due to market volatility.

- June continued May's trend with new IPOs, again proving to be the main driver of new lending opportunities. We saw demand to borrow new placements from CTC Media Inc, Town Sports International Holdings Inc, Alphatec Holdings Inc, Loopnet Inc, VeraSun Energy Corp, Golfsmith International Holdings Inc, Houston Wire and Cable Co and Volcano Corp. Convertible bonds were issued by Group 1 Automative Inc, Lifetime Brands Inc, Alleghany Corp and Level 3 Communications Inc and we also saw demand in Spansion Inc after a capital increase was announced.

U.S. Treasuries

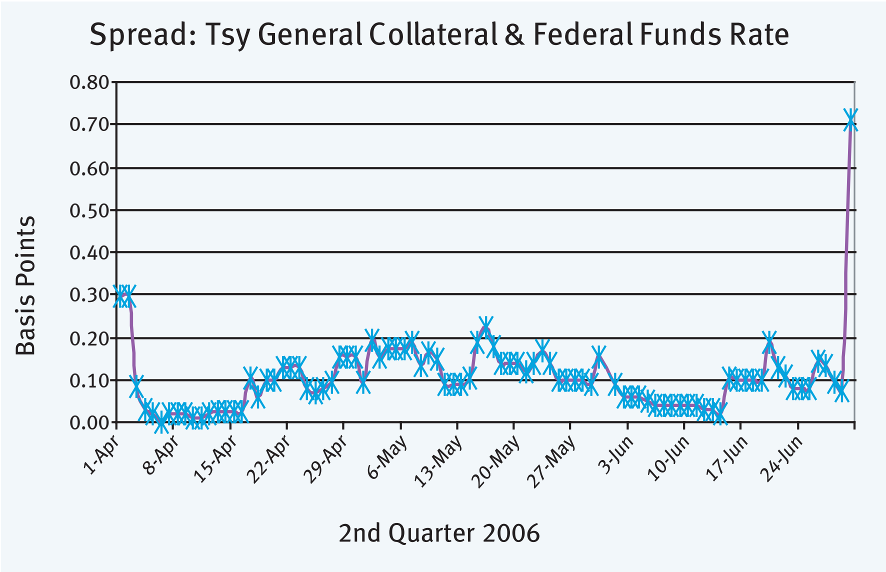
The beginning of the second quarter started with all collateral types (US Treasuries, Agencies and Agency Mortgages) trading within a couple of basis points of each other. There was ample supply of Treasuries available to the repo market as $58 billion of Cash Management Bills (CMB) were issued in early April for maturity coinciding with the April tax date. The compressed spread that started in April began to widen with the maturity of $58 billion 4/17 Bills. This was the beginning of the Treasury collateral shortage that helped increased spreads by as much as 15 basis points between Treasuries and the Federal Funds rate in April.

With the 5 year note issuance recently moved to the end of the month, the May refunding had only 2 new issues settle in the market: 3 year and 10 year notes, the first time since February 2003 that this has occurred. With the return of the quarterly 3-year note in May 2003, this was the first quarter with a maturing 3-year note, creating the largest mid-quarter note and bond payout on record.

Surprising strength in tax revenues due to recent economic growth has decreased the Treasury Department's borrowing needs in its weekly Bill auctions for the majority of May and June. Additionally, a large maturity of $106 billion 6/15 Bills reduced the supply of treasuries even further. Wider spreads between Treasuries and Fed Funds continued for the remaining trading days of the quarter, with the largest spread of 70 basis points on quarter-end 6/30.

The wide spreads between US Treasuries and Fed Funds allowed lenders to achieve record high balances in US treasury securities. Many off-the-run issues traded with wider premiums as well. To note, the shortage of US treasury collateral is historically more pronounced over quarter-ends as accounts recall securities from the market and dealers reduce their positions due to balance sheet restrictions.

In addition, the quarter-end was impacted by record pay down of US treasury debt. The Treasury ended up paying down a total of $92 billion of debt during the second quarter; $41 billion more than they estimated at the beginning of May. Due to this large pay-down this quarter, the end of 2006's 2nd quarter was seen by the repo market to be a significant event. As borrowers positioned themselves to ensure they had access to US Treasuries,



From the Trading Desks (cont'd)

rebates improved for lenders. As June 30 approached, we strategically positioned some of our loans to lock up earnings into the 3rd quarter by entering into term trades at spreads of 20-30 basis points for 1-month, while at the same time giving ourselves the flexibility of having enough open general collateral loans to capture the 70 basis-point spread over the quarter-end.

During June, US Treasury collateral term trades were allowed to roll-off to capture a quarter-end spike in spreads, or trades were rolled into 1- and 6-month trades. One month term trades allow lenders to capture quarter-end premiums and 6-month trades allow lenders to capture widening spreads as investors speculate on monetary policy. UST bills lent to maturity, with No Rights of Substitution, was the superlative trade for clients who held Treasury bills, since bills traded at a lower rebate than general collateral as traders increased their bets that the Federal Reserve was going to raise rates 25 basis points for the 17th straight time at the June 29 FOMC meeting. The 8/3 and 8/24 bills were among the favorites, generating on average 50-60 basis points.

Like any cycle, the Treasury collateral shortage will likely come to an end during the second half of 2006. It is also likely that tax revenues will begin to decrease as higher energy costs and a slower housing market could hurt economic growth. The impact could then be a growing federal budget deficit requiring the Treasury Department to increase its borrowing needs by offering more Treasury securities. If so, spreads should narrow and revert back to historical levels, thereby making term trades once again more attractive from both a revenue and utilization perspective.

Specials

There were numerous issues trading special over the 2nd quarter, with strong demand for the 10-year notes continuing throughout the period. The February-issued 10-year note, 4.50% 2/15/16 – cusip 912828EW6, traded with spreads as wide as 150 basis points during the month of April, 300 basis points during May and 100 basis points during June. The May issues 10 year note, 4.125% 5/15/16 – cusip 912828FF2, traded with spreads as high as 175 basis points during June. The 08/22 US treasury strip, cusip 912833LJ7 generated spreads as high as 400 basis points during April and 150 basis points for the remainder of the quarter.

There was also strong demand for a select number of agency issues. The Freddie Mac 4.5% 01/15/15 – cusip 3134A4UX0, traded with spreads as wide as 375 basis points during April. The Fannie Mae 4.50% 10/15/08 – cusip 31359MZH9, traded with spreads as wide as 250 basis points during May.

Corporate Bonds

As the second quarter of the year came to a close, the corporate market was still in favorable territory as issuance continues to rise. According to the Bond Market Association, the volume of corporate bonds will continue to increase for the remainder of the year. The anticipation of higher interest rates may hurt some rate-sensitive sectors, namely housing, but other parts of the market will benefit from sustained economic growth and increased business and consumer spending. The investment-grade issuance was $130 billion for the quarter. This is down slightly from the first quarter of this year, but an increase over the same period in 2005. During the same months, the high-yield issuance was about $32.5 billion for the quarter. These numbers are down slightly from the first quarter of the year also, but up from the same time period a year ago. At this pace, issuance is on track to beat last year's rate. The demand for corporate bonds in the reporting period was down slightly, according to borrowers.

The Federal Reserve has indicated by past performance that it is prepared to continue its efforts to curb inflation by raising short-term rates. Corporate-debt investors are growing concerned because economic growth is being slowed as a result. According to Moody's, the percentage of borrowers defaulting on obligations would double by mid-2007, while the market for credit derivatives used by investors to protect against corporate default has expanded to $17 trillion since 2002. (Investors use credit default swaps (CDS) to bet on a company's creditworthiness or to protect against non-payment.) Buyers pay a premium to protect an amount of debt for a specified time against a company's failure to pay. If a borrower defaults, those holding the CDS hand over

From the Trading Desks (cont'd)

the bond in exchange for full payment of the face amount of the debt. Trading in these contracts has doubled in the last two years, to $10 billion per day. As more broker/dealers get involved using CDS, the traditional short covering and bond borrowing will continue to decline, having a negative impact on lenders utilization levels. Corporate bond traders are being forced to disclose prices over a computerized system called TRACE. Dealers complain there is not much incentive to trade because it is more difficult to make a profit buying and selling when everyone has the same price information. This system typically provides price and amounts of bonds traded within fifteen minutes of execution, thus eliminating the need for guidance from analysts and salespeople.

Among the areas that were active this quarter was the paper and related products sector. Debt issues of several paper and lumber companies were trading at a premium in the repo market since early in the quarter and continue to be in demand as the quarter comes to a close. The underlying story of several issues link back to a trade dispute between U.S. and Canadian lawmakers and the collection of tariffs. Canada's biggest pulp producer, *Tembec Inc.* has had one of its bond issues, the 8.625 % note maturing in 2009 (CUSIP 87971KAA5) generate wide spreads for lenders, trading between 4.00 and 4.375 rebate since early April. Canada had tentatively agreed to cap exports to the U.S. or impose taxes on domestic producers in order for the U.S. to drop duty charges. *Abitibi-Consolidated*, the leading maker of paper for publishers and printing companies, had an issue trading at a premium since early in the quarter. *Abitibi's* 8.375 note maturing in 2015 (CUSIP 003669AJ7) generated spreads for lenders as wide as 400 basis points since January. Also involved in this trade accord is *Bowater Inc.*, another global leader in the production of newsprint and coated and specialty papers. The debt issue of *Bowater*, the 6.5 % note maturing in 2013, has traded between 4.00 and 4.25 rebate since early April and continues to be in demand as the quarter ends.

Another area whose debt issues are trading actively is the transport services and container sector. This division is being affected by the same factors that are plaguing the auto and airline industries: the higher cost of fuel. The debt issue of *Sea Containers* 811371AK9, traded at a 2.50 rebate and below early in the quarter. Another issue trading at a premium is the debt issue of *Graphic Packaging Intl.*, the 38869PAD6, which has traded at 4.00 rebate since early May. Finally, another issue seeing activity, the debt issue of Portola Packaging Inc., the 8.25 note maturing in 2012 737008AD, has been trading at 2.25 rebate since May.

Outlook

Our outlook for the 3rd quarter 2006 rests on balanced growth in the corporate-bond arena. Ben Bernanke, the current Federal Reserve chairman, says growth is a priority and his comments concerning the pace of rate increases may make bonds more attractive to investors. Investors are willing to buy riskier assets because default rates have been close to historic lows. The last time the Federal Reserve ended a series of rate increases, corporate bonds rallied for a period of more than one year. According to JPMorgan economists, corporate bonds are providing strength and resilience to the global business cycle. As noted during the 1st quarter, with the continued use of the credit default swaps as a product to assist borrowers in covering short positions, it will become more challenging for lenders to maintain current utilization levels of corporate bonds with rebates below the Federal Funds target. We will look to maintain the existing rebate structure with borrowers, however for borrowers that command higher rebates we will offer a tiered structure, where borrowers are required to maintain minimum balances at various rebate levels. Most important, the objective is to maintain the revenue flow for our clients.

International Fixed Income

Global Market Highlights

The ECB raised interest rates on June 8th by 25 basis points to 2.75% (effective June 15) – its third hike in as many quarters. There had been speculation that the ECB might have opted for a shock tactic by raising interest rates 50 basis points, but volatility in global equity markets and the strength of the euro added to the argument that the recent up-turn in economic growth was not sufficiently strong to warrant a more aggressive tightening. ECB president Jean Claude

From the Trading Desks (cont'd)

Trichet said interest rates were still "low" in the 12 euro nations. "Our monetary policy is accommodative. We will continue to monitor closely all developments to ensure price stability over the medium and long term," he said. Hawkish comments and stronger data fostered expectations of an imminent change in pace by the ECB, but a further hike in July looks unlikely while one in August appears to be a certainty.

As expected, the Fed raised interest rates by 25 basis points on 29 June, to 5.25%, marking the U.S. central bank's 17th consecutive increase. On balance, the policy statement was more dovish than expected, acknowledging that economic growth in the U.S. is moderating. The phrase included in May's statement, "the committee judges that some further policy firming may be needed," was removed in June. However, it also acknowledged that core inflation pressures have risen, leaving the Fed in data-watching mode. Overall, the bias toward higher rates remains, and a further hike at the August meeting is generally expected.

In the UK, the Bank of England's MPC met on June 8 and voted to leave rates on hold at 4.5%. However, a quarter-point increase by end of 2006 is almost fully priced into the market.

In the emerging markets we saw political issues, buyback pressure, and higher rates in the U.S. causing volatile cash markets, a trend that filtered over to the repo markets over the quarter. The strong run-up and then sell-off in commodity prices in April (EM countries are exporters of commodities so they tend to fair better with higher prices) added to the volatility. Emerging market countries have bought back approximately USD $30 billion of international debt so far this year. Expectations are that developing nations' corporate and local debt markets will grow as EM countries grow in global importance. Investments in their local markets will become part of any global fixed income allocation.

To be sure, Argentina's economy expanded by 8.0% year-on-year during April and 8.7% during the first four months of 2006. In the last four years, the economy has expanded almost 40%. While the country has enjoyed three consecutive years of fiscal and trade surplus, insufficient investment and rising inflation rates could undermine the sustainability of these positives.

In Brazil, conditions were closer to global median trends. Brazilian GDP grew by 1.4% during the first quarter of this year, the best performance since the third quarter of 2004, which could result in an overall increase of between 3.5 and 4% for 2006.

Emerging markets specials update

Argentina 8.28 12/33 'disco' (US040114GL81) was very special for the quarter, trading between 300 and 450 basis points for much of the period. The U.S. Federal Reserve rate hikes in May and June meant that even more value was available for the most special emerging market bonds. Liquidity in this issue remains reasonable and we have not seen any long-term fails.

The benchmark Brazilian issue, Brazil 11% 8/40 (US105756AP53), remained fully lent, but spreads were generally much lower than we have seen for some time, ranging from the worst at 15 basis points, with 100 basis points attainable at times. Term rates indicate that this issue will remain in demand, though not at the levels that we saw throughout last year. Meanwhile, the new Brazil global issue, Brazil 7.125 1/37 (US105756BK57), was worth between 10 and 150 basis points during May, but demand does not seem to be as deep as with the other Brazilian specials. Finally in Brazil, there was a pick-up in activity in Brazil A 8 1/18 (US105756BH29) again in May. Although only worth 10 basis points at the start of May, it gradually increased in value to trade at 250 basis points by early June. This issue has been subject to repo squeezes since issue last August.

In a repeat of the last few months' activity, Turkey 11.875% 30 (US900123AL40) was very volatile and traded around 425 basis points throughout much of the quarter,

From the Trading Desks (cont'd)

mainly due to repo shorts. This issue is the benchmark and still very well bid out to six months, so it appears currently that this value will continue for a while yet.

Other emerging market specials traded this quarter:

Jamaica 9.25 10/25 (US470160AT99) – 10 to 150 basis points

Pemex 6.625 6/35 (US706451BG56) – 25 to 225 basis points

Venezuela 7.65 4/25 (XS0217249126) – 50 to 200 basis points

Venezuela 9.25 27 (US922646AS37) – 25 to 175 basis points

UMS 6.75 9/34 (US91086QAS75) – 50 to 125 basis points

Peru 7.35 7/25 (US715638AS19) – 10 to 125 basis points

Philippines 2016 (US718286BA41) – 200 to 400 basis points

Philippines 2025 (US718286AP29) – 150 to 250 basis points

Philippines 2031 (US718286BB24) – 500 basis points

Euro government update

Euro government volumes were high again in May and as we approached June futures expiry, a few German issues started to pick up in value. These included:

DBR 3.75 1/09 (DE0001135101) was worth up to 80 basis points towards the end of May but only 20 basis points in June.

OBL 142 (DE0001141448) was in high demand in throughout the quarter but only traded at 10-20 basis points.

DBR 3.75 1/15 (DE0001135267) was in high demand as we approached futures expiry and traded up to 85 basis points in short dates at the start of June. In the last few days before the bond needed to be boxed before the delivery, it was worth up to 200 basis points, before trading back to GC levels.

DBR 4 1/37 (DE0001135275) seemed to have a high number of shorts which led to sporadic interest throughout the quarter. Rates were up to 20 basis points but the average was a little more than 10 basis points. The issue is scheduled to be tapped on July 26 but speculation that it will not be, should it be trading at 6 basis points below par, led to some tightening in the 1 month term market in June (to 17 basis points through GC).

DBR 3.25 7/15 (DE0001135283) traded at up to 30 basis points on open amid much term interest. There seems to be a belief that this issue will gain more value into September delivery (it's deliverable into the 10 year Bund future) but generally it was closer to GC short dates during this quarter.

Other sovereigns

In Australia, ACGB 5.75 6/11 (AU0000XCLWG7) was special for another month, trading between 10 and 60 basis points, while ACGB 6.25 4/15 (AU0000XCLWI3) was worth 15 basis points.

In NZ, NZGB 6 4/15 (NZGOVD0004R7) traded special for another month, averaging 65 to 75 basis points over May.

UK Gilts

Demand was subdued after the Bank of England changed the way it manages money market operations, successfully reducing overnight sterling volatility. This together with the fact that many borrowers appeared to be long collateral ahead of these changes meant that specials were very rare.

Term General Collateral Update

May brought another record balance in lending EUR sovereigns from 1-6 months with right of substitution. Reinvest was mainly in CP, with spreads being 7 basis points in 1 month, 8 basis points in 2 months and 8 to 10 basis points in 3 and 6 months, depending on the CP issuer. Germany, France, Netherlands, Belgium and Austria were fully lent for clients who permit this trade. The desk put together a paper detailing the CP market for any client that may be interested in increasing his or her securities lending revenue by reinvesting in this asset class, and we encourage all clients to contact your securities lending representative for more details.

From the Trading Desks (cont'd)

Specific Corporate Specials

Demand was still high for specific names and a few traded at higher spreads, with the most significant activity still in the perpetual and high-yield sectors.

EUR

Thomson frn perp (FR0010237016) – 100 basis points

Duerr 9.75 7/11 (XS0195957658) – 275 basis points (much improved)

Grohe 8.625 10/14 (XS0200848041) – 125 basis points

Hellas 8.5 10/13 (XS0231415588) – 100 basis points

DT 7.5% 1/33 (XS0161488498) – 200 basis points on constant demand

Linde 6% perp (XS0171231060) – 100 basis points

RWE 0.875 conv 4/07 (DE0003723144) – 125 basis points

Sudzucker 3% conv 8/08 (DE000A0AABH1) – 150 basis points

Jentoptik 7.875 11/10 (XS0178552716) – 115 basis points

BAWAG 8.765 perp (XS0119643897) – 180 basis points (financial crisis due to loan write offs and losses on derivatives)

Hanrue 6.25 3/31 (XS0126063386) – 100 basis points

USD

KFW 5.125 3/16 (US500769BP83) – 175 basis points (repo squeeze)

Outlook

We believe emerging market sovereigns will generally trade less special in the fewer short term, and although specific issues remain very tight, there will likely be fewer of them. Demand for European governments is gradually increasing but collateral flexibility remains the key to high utilization. UK gilt demand looks set to remain lower than of late, as the market adjusts to the new overnight rate conditions.

For more information on Securities Lending, please contact:

Western Hemisphere
New York
Gene Picone
Tel: (212) 623-2938
Email: eugene.picone@jpmorgan.com

Jim Wilson
Tel: (212) 623-3756
Email: jim.wilson@jpmorgan.com

Europe, Middle East & Africa
London
Paul Wilson
Tel: (44-20) 7-742-0249
Email: paul.uk.wilson@jpmorgan.com

Michelle Phillips
Tel: (44-20) 7-777-3912
Email: michelle.phillips@jpmorgan.com

Asia Pacific
Sydney
David Brown
Tel: (61-2) 9250 4606
Email: david.ldn.brown@jpmorgan.com

www.jpmorgan.com/securitieslending